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UNCLASSIFIED
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MEMORANDUM FOR THE VICE PRESIDENT
THE SECRETARY OF STATE
THE SECRETARY OF DEFENSE
THE SECRETARY OF AGRICULTURE
THE SECRETARY OF COMMERCE
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
DIRECTOR OF CENTRAL INTELLIGENCE
UNITED STATES TRADE REPRESENTATIVE
ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS
ASSISTANT TO THE PRESIDENT & DEPUTY TO THE CHIEF OF STAFF
ASSISTANT TO THE PRESIDENT FOR CABINET AFFAIRS
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS
ASSISTANT TO THE PRESIDENT FOR POLICY DEVELOPMENT
ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

SUBJECT: Senior Interdepartmental Group on International Economic Policy (SIG-IEP)

A meeting of the SIG-IEP is scheduled to be held on Monday, May 14, 2:00 p.m., in the Roosevelt Room.

The agenda is as follows:

1. Status Report on the International Debt Strategy; and
2. International Debt Update.

A discussion paper on agenda item 1 is attached.

Attendance will be principal, plus one.

DTR
Donald T. Regan

Attachment

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SIG-IEP

Status Report on the International Debt Strategy

This paper provides a brief review of progress in implementing the internationally-agreed debt strategy, in line with NSDD-8's call for regular monitoring by the SIG and IG. It concludes that progress has been made and that the strategy continues to be effective. Although the situation requires vigilance, the approach is proving to be both comprehensive and flexible enough to respond to changing circumstances and widely differing cases.

Elements of Strategy

The strategy consists of five elements: (1) economic adjustment by the debtor countries; (2) economic recovery, sustained growth and open markets in the industrialized countries; (3) adequate resources for the International Monetary Fund (IMF); (4) continued commercial bank lending for countries making determined adjustment efforts; and (5) readiness to provide bridge financing as necessary from central banks and governments, on a case-by-case basis, in support of adjustment efforts.

The strategy is designed to focus attention on, and support achievement of, adjustment to restore long-term growth. It permits needed flexibility in confronting individual country circumstances and short-term financing needs, while maintaining the pressure for necessary changes in economic policies. Given the size of international capital markets, private lending and direct investment will have to continue to be the most important source of balance of payments financing. The focus on corrective policy measures is crucial not only to creating the domestic conditions for sustainable growth, but also for restoring the creditworthiness needed for LDCs to attract private financing.

Concern that the approach is too ad hoc reflects a misunderstanding of the strategy. No single specific formula is appropriate for all debt problems: levels of official assistance must depend on the severity of adjustment burdens, the strength of adjustment efforts, and the degree of threat to the system. Financing must be adequate to support orderly adjustment but should not act as a disincentive to adjustment.

Implementation of the Strategy

The central element of the strategy is that debtor countries adopt comprehensive, credible and effective programs for strengthening their balance of payments and stabilizing their economies. Generally, these are policies that reduce internal imbalances commonly associated with excessive government spending and price controls, that encourage investment and that make domestic production more competitive in international markets. Although a few debtors have failed to make serious efforts to put into place a credible adjustment program, the overwhelming majority have, in fact, made substantial progress in adjustment efforts. Adjustment is not just a short-term corrective: it is a long-term necessity. It has always been seen as a multi-year process for many countries, but one which offers the best chance of integrating LDCs more fully and productively into the global economy.

Progress is also being made on the second element -- economic recovery, sustained growth, and open markets in industrial countries. Recovery in the industrial world, led by the strong U.S. economy, is clearly underway. This recovery is already having a positive impact on the exports of many major debtors, which is being reflected in our own trade deficit. Developing country growth is expected to average 4.5 percent annually over the 1985-90 period. Unfortunately there have been steps toward protectionism, but efforts are underway to roll back these measures.

The IMF has been considerably strengthened over the past year, both by increases in its resources and changes in its lending policies. On the resource side, the IMF's position was enhanced by the increase in quotas, the enlargement and modification of the General Arrangements to Borrow (GAB), and recently concluded borrowing arrangements. These have all reinforced the Fund's capacity to provide temporary balance of payments financing in support of adjustment efforts. On the lending side, changes agreed last fall in the IMF's access policy represent an important step toward safeguarding the IMF's focus on effective adjustment and ensuring that the IMF lives within its means.

The fourth element is continued commercial bank lending for countries making determined adjustment efforts. Commercial banks generally have shown a willingness not only to continue lending to these countries, but to do so on better terms in cases where the debtor is making clear progress in its adjustment program. Both Mexico and Brazil are examples of countries which have managed to obtain additional lending on better terms in the light of improved economic policies and performance.

The fifth element concerns the readiness of creditor governments to provide bridge financing on a selective basis when appropriate. The U.S. and other creditor governments have provided short-term bridge financing on a number of occasions to debtors in support of adjustment efforts.

Impact of Strategy in Key LDCs

Several of the major LDC debtor nations, including Brazil and Mexico, have already made major economic progress under the strategy. Their progress acts to underscore the relevance of the strategy to those debtors which have yet to initiate effective adjustment efforts, including Argentina and Venezuela.

Brazil

Economic adjustment is well underway as a result of major policy reforms beginning in mid-1983. Brazil's external accounts have recovered dramatically and external financing needs for 1984 have been met. Bank financing needs in 1985 will only be some $3-3.5 billion. Strong export performance, increased domestic oil output, and import substitution in the last two years assure a trade surplus of $9.5 billion this year and over $11 billion in 1985. A more realistic exchange rate policy is helping to put Brazilian manufactures in an excellent competitive position.

Domestic economic performance is also improving. Inflation may have peaked in February. The economy is showing strong signs of recovery, led by agriculture and exports, and should be growing at an annual rate of 3-4 percent by year-end.

Mexico

Mexico has made significant progress in improving its economic and financial position, reflecting continued compliance with its IMF program.

The domestic economy appears to have bottomed out and Mexico will experience slight real positive GDP growth in 1984, compared with a 5 percent drop in 1983. We also expect continued progress in controlling the fiscal deficit and inflation. Although imports are expected to pick up in 1984 due to expanded economic activity, we still anticipate a $2 billion current account surplus as exports also increase. The terms of the $3.8 billion 1984 financing package reflect the success of Mexico's adjustment efforts, as spreads (1-1/2 percent over LIBOR) are substantially better than those of the 1983 package (2-1/4 percent over LIBOR).

Argentina

Argentina is suffering from excessive aggregate demand, led by a very large public sector deficit in 1983 (18 percent of GDP) combined with an expansionary monetary policy. Inflation in March exceeded 20 percent (monthly rate) and the rate for April is projected at 18-19 percent. Argentina needs to curb public sector expenditures and curtail the wage-price spiral.

An agreement with the IMF is essential if it is to have a chance at meeting its external financing requirements. The USG supported the March 30 multilateral financing package to provide Argentina time to negotiate a stand-by program, and to avoid a precipitous contraction of international credit to Argentina. We believe Argentina recognizes the need to reach agreement with the IMF.

Venezuela

Venezuela's overall policy framework is still inadequate and 1984 is likely to be the sixth consecutive year of negative or low real GDP growth. Despite some improvements in exchange rate management and fiscal policy, the climate of pervasive controls is not conducive to efficient economic recovery and does not address a longstanding need to diversify the structure of production and exports.

The strengthening of Venezuela's balance of payments position ($2.6 billion 1983 current account surplus, compared with 1982's $3.5 billion deficit), the drop in inflation to 7 percent in 1983, and the growth of international reserves to $11.2 billion (including $5.4 billion in liquid, non-gold reserves) reflect import and price controls and the accumulation of arrears, rather than fundamental structural changes. Continuous reduction of imports is not a sustainable long-term strategy for maintaining external balance, and the impact of Venezuela's current approach can be seen in the long-standing downturn in real GDP. The GOV needs IMF support for a coherent adjustment program but has so far refused to obtain it.

Conclusion

The debt strategy has proved effective to date. It is sufficiently comprehensive and flexible to meet anticipated strains. Resolution of debt problems and restoration of sustainable economic growth (requiring reversal of years of inappropriate policies) will, however, take time.

To a large extent, progress in managing the debt problem stems from the strategy's ability to keep pressure on debtors to implement appropriate domestic policies. In turn, adjustment efforts have encouraged banks to keep extending new loans to less developed country debtors. The medium-term will not lack problems in individual countries, but we do have a working and workable strategy in place to deal with them.